Internal Revenue Service
memorandum

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to: District Counsel, New Orleans, LA
ATTN: Arlene Blume

from: Chief, Branch 5, Office of Chief Counsel (International)

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subject: [redacted]
Apportionment of statutory adjustments to Life Insurance Company Taxable Income for purposes of §904 of the Code

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[redacted] is a U.S. corporation which files a consolidated U.S. life insurance company income tax return for itself, [redacted], and [redacted]. [redacted] and its affiliates operate branches in several Central and South American countries.

This is in reply to your request for informal technical assistance regarding the application of §1.861-8 to two life insurance company deductions. The first relates to the special life insurance company deduction under §806(a). The second issue relates to the increase in a life insurance company's policyholder dividend deductions under §808 attributable to the reduction in equity base under §809(g)(5) for business in noncontiguous Western Hemisphere countries.

Regarding the first issue, we believe that the special life insurance company deduction under §806(a) of the 1954 Code should be allocated on the basis of tentative life insurance company <u>taxable</u> income (LICTI) rather than gross income because the amount of the special life insurance company deduction is a function of tentative LICTI. With respect to the second issue, we believe that the increase in a life insurance company's policyholder dividend deduction under §808 attributable to the reduction in equity base under §809(g)(5) for business in certain noncontiguous Western Hemisphere countries should be allocated to life insurance company gross income from contracts issued to policyholders resident in those noncontiguous Western Hemisphere countries.

I. SMALL LIFE INSURANCE COMPANY DEDUCTION

For taxable years beginning after December 31, 1984 and before January 1, 1987, there was a special life insurance company deduction under §806(a) equal to 20% of the amount by which tentative LICTI exceeded the small life insurance company deduction of §806(b).[1] Tentative LICTI is generally a life insurance company's gross income determined without regard to (1) the special life insurance company deduction and small life insurance company deductions, and (2) any items (income or loss) attributable to noninsurance business. §806(c).

Life insurance companies that are members of the same controlled group such as [redacted], [redacted], and [redacted], are treated as one company for purposes of determining the group's eligibility for, and computation of, the special life insurance company deduction. The group's deduction is allocated according to each member's tentative LICTI. §806(d)(1). Congress intended the allocation to be made only to group members with positive tentative LICTI. <u>See</u>, S.Prt. No. 169, 98th Cong., 2d Sess. (1984), vol. I, at 532, and H.Rep. No. 432, 98th Cong., 1st Sess., vol. I, at 108 (1983). Thus, while the [redacted] affiliated group claimed the special life insurance company deduction for the tax years [redacted] through [redacted], none of the deduction was allocated to [redacted] because it had negative tentative LICTI.

For purposes of computing its §904 limitation, [redacted] apportioned its special life insurance company deduction among U.S. and foreign source income based on the relative amounts of U.S. and foreign source gross income to its total gross income. [redacted] based its position on the legislative history to §818(f) which stated that the special life insurance company deduction cannot be definitely allocated to an item or class of gross income for purposes of computing the §904 foreign tax credit limitation. <u>See</u> S.Prt. No. 169 at p. 560 and H.Rep. No. 432 at p. 134. Exam proposes to apportion the deduction based on the relative amounts of positive U.S. source taxable income (without regard to the special life

[1]The special life insurance company deduction was repealed by the Tax Reform Act of 1986 and the small life insurance company deduction was moved from §806(b) to §806(a).

insurance company deduction) and positive foreign source taxable income of its branches. Branches showing an operating loss would be removed from the equation.

For the following reasons we believe that the special life insurance company deduction should be apportioned between U.S. source and foreign source LICTI (including loss branches).

Normally, a deduction that is not definitely related to any gross income, such as the special life insurance company deduction, must be ratably apportioned between U.S. and foreign source gross income. §1.861-8(c)(3). However, this general rule assumes that the deduction is factually related to gross income. §1.861-8(b). The amount of a controlled group's special life insurance company deduction is computed as a percentage of the group's tentative LICTI and is allocated only to group members with positive LICTI. Because LICTI is a taxable figure, the deduction is factually related, within the meaning of §1.861-8, to tentative LICTI and not gross income. Where a deduction such as the special life insurance company deduction is factually related to a taxable income figure, the principles of §1.861-8 require that the deduction be allocated to groupings of taxable income rather than gross income.

An analogous situation is the treatment under §1.861-8 of the Western Hemisphere trade corporation deduction under §922 which was also based on a percentage of net income.[2] Under §1.861-8(e)(10), the deduction had to be allocated consistent with the principles of §1.861-8. Charlie Saverude, an attorney in CC:INTL who was involved in drafting the §1.861-8(e)(10), believes that the §922 deduction was intended to be allocated on the basis of taxable (rather than gross) income because it was factually related to taxable income, not gross income, being a deduction from taxable income, not gross income. This is consistent with Rev. Rul. 58-618, 1958-1 C.B. 430. The ruling held, in part, that in computing the §904 limitation the §922 deduction must be allocated only among profitable companies of an affiliated group on the basis of the ratio of their respective net incomes to their combined net income.

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[2]The special deduction for Western Hemisphere trade corporations contained in §922 was repealed by P.L 94-455 effective for taxable years beginning after December 31, 1979.

However, we do not believe that it is appropriate to exclude loss branches from the apportionment under §1.861-8 of the special life insurance company deduction. For the years in question, the §904(a) limitation was not computed on a per country basis, but rather on an overall basis. Additionally, the special life insurance company deduction is computed as a percentage of the affiliated group's LICTI. Thus, even though [redacted] had operating losses in a particular country, those losses must be included in the determination of its taxable income. To do otherwise would in effect result in apportioning the special life insurance company deduction on a per country rather than overall basis, and would not follow the matching principles of §1.861-8.

II. NONCONTIGUOUS WESTERN HEMISPHERE COUNTRIES

Section 808 allows life insurance companies a deduction for dividends or similar distributions paid to policyholders in their capacity as such. Congress believed that a portion of the policyholder dividend paid by a mutual company was a distribution of earnings for which a deduction should not be allowed. Therefore §809 requires a mutual life insurance company to reduce the §808 policyholder dividend deduction (but not below zero) by the "differential earnings amount." Section 809 provides a formula for computing the differential earnings amount based on a mutual company's equity base for the taxable year. Generally, the equity base equals surplus and capital of the mutual life insurance company with certain modifications. Thus, a reduction in the equity base increases the amount of the policyholder dividend deduction.

Section 809(g)(5) generally provides[3] that the equity base of any mutual life insurance company is reduced by that portion of the equity base attributable to the life insurance business allocable to reserves or liabilities for life insurance contracts issued on the life of residents of Western Hemisphere countries that are noncontiguous to the United States. The equity allocable to those contracts equals the portion of the equity base attributable to the life insurance business multiplied by a fraction the numerator of which is the portion of the tax reserves allocable to life insurance contracts issued on the life of residents of countries in the Western Hemisphere which are not contiguous to the United States, and the denominator of which is the amount of total tax reserves allocable to life insurance contracts (if that

[3]This provision was added to the Code in 1984 apparently at [redacted]'s request.

proportion is at least 1 to 20). This modification recognizes "that a company may need to maintain higher levels of surplus because of the special classification or substandard nature of certain insured living in foreign countries undergoing civil strife." S.Prt. 169, 98th Cong., 2d Sess, vol. I at p. 552. In summary, reducing the equity base increases the amount of the policyholder dividend deduction, thereby decreasing LICTI.

In computing its §904 limitation for [redacted], [redacted] apportioned the policyholder dividend deduction among its domestic and foreign branches based upon the total dividends paid in each country, thus allocating a portion of the increased deduction to U.S. source income.

Exam contends that the reduction in equity base attributable to noncontiguous Western Hemisphere country business should be applied only to dividends paid in those noncontiguous Western Hemisphere countries because only business from those countries caused a decrease in the equity base and, thus, a larger §808 deduction than would have been allowed absent any such business. Thus, Exam proposes to allocate the increased §808 deduction caused by its business in the noncontiguous Western Hemisphere countries only to gross income from those countries. For the following reasons we agree.

As outlined above, §1.861-8 generally provides that all deductions must be allocated and apportioned based on the factual relationship that a specific deduction bears to the income. If there is no such specific factual relationship, deductions are apportioned ratably against foreign source and U.S. source income. §1.861-8(a)(2) and (3).

Deductions attributable to, and computed on, the equity base attributable to life insurance contracts issued on the life of residents of noncontiguous Western Hemisphere countries are directly related to the dividends paid out of income earned by the noncontiguous Western Hemisphere branches. Therefore, the deductions are allocable under §1.861-8 only to the insurance income attributable to such contracts.

Thus, the increase in [redacted]s policyholder dividend deduction attributable to §809(g)(5) is allocable to life insurance company gross income from contracts issued to policyholders resident in certain noncontiguous Western Hemisphere countries.

If you have any additional questions, please contact Mary Gillmarten at FTS 566-6284.

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